Supreme Court, U.S.
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89-935

NO. _____

IN THE

Supreme Court of the United States

OCTOBER TERM, 1989

LIVELY EXPLORATION COMPANY, ET AL.,
Appellants

v.

VALERO TRANSMISSION COMPANY,
Appellee

On Appeal From The Court of Appeals For The Fourth Supreme Judicial District of Texas

JURISDICTIONAL STATEMENT

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December 7, 1989

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QUESTIONS PRESENTED

1. Whether the Railroad Commission of Texas Gas Market Demand Rule as applied by a Texas Court of Appeals voiding take-or-pay obligations and liability in a natural gas purchase contract is preempted by the Natural Gas Policy Act.

2. Whether the Railroad Commission of Texas Gas Market Demand Rule as applied by a Texas Court of Appeals voiding take-or-pay obligations and liability in a natural gas purchase contract violates the Commerce Clause of the United States Constitution.

COMPLETE LIST OF PARTIES

Appellants: Lively Exploration Company, Lea Roy Aldwell, Individually, Lea Roy Aldwell, Winnie Lea McPherson and Marjory Reba Johansen, as Testamentary Trustees under the Will of George L. Aldwell, Deceased, Jon A. Sonnen, J. Howard Marshall, Ed Farrell, Elizabeth Standish, The Desana Corporation, Jessee L. Dally, Chester H. Kenley, Carolyn H. Joseph, Independent Executrix of the Estate of Gifford E. Joseph, Deceased, H. B. Lively, B. Jackson Bandy, Robert L. Banks, Theo B. Bean, William R. Gifford, Charlie Gill, Jr., Henry Gunders and wife, Elaine Gunders, Kenneth L. Hewitt, Kallman Nashner, Frank Pace, Jr., Martin B. Seretean, Ray B. Vaughters, and Theodore L. Wilkinson.

Appellee: Valero Transmission Company.

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Lively Exploration Company, Lea Roy Aldwell, Individually, Lea Roy Aldwell, Winnie Lea McPherson and Marjory Reba Johansen, as Testamentary Trustees under the will of George L. Aldwell, Deceased, Jon A. Sonnen, J. Howard Marshall, Ed Farrell, Elizabeth Standish, The Desana Corporation, Jessee L. Dally, Chester H. Kenley, Carolyn H. Joseph, Independent Executrix of the Estate of Gifford E. Joseph, Deceased, H. B. Lively, B. Jackson Bandy, Robert L. Banks, Theo B. Bean, William R. Gifford, Charlie Gill, Jr., Henry Gunders and wife, Elaine Gunders, Kenneth L. Hewitt, Kallman Nashner, Frank Pace, Jr., Martin B. Seretean, Ray B. Vaughters, and Theodore L. Wilkinson (collectively referred to as "Appellants") appeal from the final judgment of the

Court of Appeals for the Fourth Supreme Judicial District of Texas, San Antonio, Texas ("Texas Court of Appeals") entered in this action on March 31, 1988, as modified on rehearing May 18, 1988, affirming the trial court and applying the Railroad Commission of Texas Gas Market Demand Rule so as to relieve Valero Transmission Company ("Appellee") of its take-or-pay obligations and liability under its contract with Appellants despite Appellants' argument that the Texas Court of Appeals' application of the Texas Gas Market Demand Rule violates the Natural Gas Policy Act of 1978, 15 U.S.C. §§ 3301-3432, and the Commerce Clause of the United States Constitution, U.S. CONST., art. I, § 8, cl. 3.

OPINIONS BELOW

The opinion of the Texas Court of Appeals of March 31, 1988, is in the Appendix hereto, p. 1. The opinion of the Texas Court of Appeals on rehearing of May 18, 1988, is reported at 751 S.W.2d 649 and is in the Appendix, p. 16.

JURISDICTION

The Supreme Court of Texas denied Appellants' application for writ of error on June 7, 1989. Appendix, p. 32. A motion for rehearing was filed and overruled on September 13, 1989. Appendix pp. 125, 34. The judgment of the Texas Court of Appeals is the judgment appealed from, since the Texas Supreme Court denied discretionary review. *Interstate Circuit, Inc. v. City of Dallas*, 390 U.S. 676, 678 n. 1 (1968).

A notice of appeal to this Court was timely filed in the Texas Court of Appeals and also filed with the Texas Supreme Court on September 22, 1989. Appendix, p. 38.

This appeal is being docketed in this Court within 90 days from the denial of rehearing by the Texas Supreme Court. The jurisdiction of the Court is invoked under 28 U.S.C. § 1257(2), which was *amended by* 28 U.S.C. § 1257 (1988). Appeal under the prior version of Section 1257 is proper because the judgment of the Texas Court of Appeals appealed from was entered prior to the September 25, 1988, effective date of the 1988 amendment, which abolished "appeal" bases for review by this Court.

CONSTITUTIONAL PROVISIONS, STATUTES, AND RULES

U.S. CONST., art. I, § 8, cl. 3:

> The Congress shall have the power . . . [t]o regulate Commerce . . . among the several States. . . .

U.S. CONST., art. VI:

> This Constitution, and the Laws of the United States which shall be made in Pursuance thereof . . . shall be the supreme Law of the Land; and the Judges in every State shall be bound thereby, any Thing in the Constitution or Laws of any State to the Contrary notwithstanding.

Natural Gas Act of 1938, 15 U.S.C. §§ 717-717w ("NGA"). The full text of the NGA is at Appendix, p. 137.

Natural Gas Policy Act of 1978, 15 U.S.C. §§ 3301-3432 ("NGPA"). The full text of the NGPA is at Appendix, p. 169.

Railroad Commission of Texas Gas Market Demand Rule, 16 Tex. Admin. Code §§ 3.30 and 3.34. The full text of the Texas Gas Market Demand Rule is at Appendix, p. 286.

HOW THE FEDERAL QUESTION WAS RAISED

At the first opportunity, Appellants raised the claim that the Texas Gas Market Demand Rule as applied by the Texas Court of Appeals violates the NGPA and the Commerce Clause of the United States Constitution. Appellants' motion for rehearing before the Texas Court of Appeals argued that:

> The Court's action in applying the Texas Gas Market Demand Rule so as to relieve Valero of its take-or-pay obligations and liability under the contract is invalid because the Texas Gas Market Demand Rule as applied by the Court is pre-empted by the Natural Gas Policy Act of 1978 ("NGPA"), 15 U.S.C. §§ 3301 *et seq.*, and violates the Commerce Clause of the United States Constitution, U.S. Const. art. I, § 8, cl. 3.

Appendix, p. 57. Appellants' motion for rehearing in the Texas Court of Appeals raised the following points of error:

> 23. Point of Error: The Court's action in applying the Texas Gas Market Demand Rule so as to relieve Valero of its take-or-pay obligations and liability under the contract is invalid because the Texas Gas Market Demand Rule as applied by the Court is pre-empted by the Natural Gas Policy Act.
>
> 24. Point of Error: The Court's action in applying the Texas Gas Market Demand Rule so as to relieve Valero of its take-or-pay obligations and liability under the contract is invalid because the Texas Gas Market Demand Rule as applied by the Court violates the Commerce Clause of the United States Constitution.

Appendix, p. 57. Points of Error Nos. 23 and 24 were not raised prior to Appellants' motion for rehearing—which was denied by the Court of Appeals in a new opinion that did not address the Constitutional questions Appellants raised—because the error complained of was created by the opinion of the Texas Court of Appeals. The Texas Court of Appeals' opinion, and not any action of the trial court, was the basis for Points of Error Nos. 23 and 24.

This Court has consistently recognized that a federal question is timely and properly presented in a motion for rehearing to a state court when the basis for decision of that state court creates the federal question. *See, e.g., Herndon v. Georgia,* 295 U.S. 441, 443-44 (1935); *Great Northern Railway Co. v. Sunburst Oil & Refining Co.,* 287 U.S. 358, 367 (1932); *Brinkerhoff-Faris Trust & Savings Co. v. Hill,* 281 U.S. 673, 678 (1930); *Missouri ex rel v. Missouri Insurance Co. v. Gehner,* 281 U.S. 313, 320-21 (1930). In addition, Rule 131(e) of the Texas Rules of Appellate Procedure recognizes that a point of error may be raised for the first time in a motion for rehearing in the court of appeals when the error originates in the court of appeals. Rule 131(e) provides in pertinent part: "Whether the matter complained of originated in the trial court or in the court of appeals, it shall be assigned as error in the motion for rehearing in the court of appeals." Under Rule 131(e):

> [A] point in a motion for rehearing can also be grounded on error that originated in the court of appeals. . . .
>
> Obviously, these errors could not have been raised earlier, since they occur for the first time when the court of appeals renders its judgment. Thus, they are

> not waived merely because they are presented for the first time in a timely filed motion for rehearing.

31 J. Wicker, Civil Trial and Appellate Procedure § 779, at 552-53 (Texas Practice 1985).

The preemption and Commerce Clause issues were urged also in Points of Error Nos. 12 and 13 in Appellants' Application for Writ of Error to the Supreme Court of Texas. Points of Error Nos. 12 and 13 are as follows:

> POINT 12. The Court of Appeals' action in applying the Texas Gas Market Demand Rule so as to relieve Valero of its take-or-pay obligations and liability under the contract is invalid, because the Texas Gas Market Demand Rule as applied by the Court of Appeals is pre-empted by the Natural Gas Policy Act.
>
> [Germane to: Point of Error 23, Appellants' Motion for Rehearing.]
>
> POINT 13. The Court of Appeals' action in applying the Texas Gas Market Demand Rule so as to relieve Valero of its take-or-pay obligations and liability under the contract is invalid, because the Texas Gas Market Demand Rule as applied by the court of appeals violates the Commerce Clause of the United States Constitution.
>
> [Germane to: Point of Error 24, Appellants' Motion for Rehearing.]

Petitioners' Application for Writ of Error, Appendix, pp. 77-8. Appellant reurged those same points of error in its motion for rehearing on the Texas Supreme Court's denial of Appellants' application for writ of error. Petitioners' Motion for Rehearing, Appendix, p. 129.

STATEMENT OF THE CASE

The contract in question was entered into in 1973 between Appellants and Lo-Vaca Gathering Company, Appellee's predecessor. It grants to Appellee the exclusive right and the obligation to purchase all of Appellants' gas from the Contract Area for a period of 20 years.

The contract provides that Appellee will, for each Contract Year, either (1) take delivery of and pay for the Daily Contract Quantity of natural gas or (2) pay for the Daily Contract Quantity of natural gas, whether taken or not. The Daily Contract Quantity is defined as a quantity of gas equal to 90% of Appellants' daily deliverability of gas averaged over the Contract Year. The quantity of gas to be purchased by Appellee each Contract Year is determined by multiplying the Daily Contract Quantity by the number of days during the Contract Year during which Appellee's performance was not excused by the contract.

Article V, ¶ 5.3, of the contract provides in pertinent part as follows:

> Subject to the other provisions hereof, Buyer agrees to purchase and pay for (*or*, if Buyer's performance hereunder is not excused by other provisions of this Agreement, *pay for, if available, whether taken or not*) during the days of each contract year of the term hereof *a Daily Contract Quantity of gas from Sellers' Lands and Leases in the Contract Area equal to ninety percent (90%) of Sellers' daily Deliverability of gas hereunder.* Upon request by Buyer or Seller, *Sellers' Deliverability shall be determined and established by Buyer by testing the actual ability of Sellers' wells to deliver into Buyer's facilities at the*

> *points of delivery;* provided, however, neither Seller nor Buyer shall request such Deliverability test more often than once in any ninety (90) day period. Such Deliverability tests shall be made after a stabilized rate of flow has been achieved against such pressure as is required to deliver into Buyer's facilities at the operating pressure at the points of delivery at the time of the test. . . .[1]

This provision in the contract is commonly known in the oil and gas industry as a "take-or-pay" clause.

The contract also contains a general definition of the term "deliverability" which differs from the specific use of that term in the take-or-pay provision quoted above. Article I(j) of the contract defines the term "deliverability" as:

> [T]hat quantity of gas which Seller has available for delivery from the Lands and Leases to Buyer during each day, in conformity with the requirements of this Agreement, at a constant rate of flow, when Seller's wells and facilities are not produced in excess of their maximum efficient rate of flow, but not exceeding the maximum (including overproduction) rate of flow permitted by the laws, rules and regulations of the Railroad Commission of Texas or other governmental regulatory agency having jurisdiction. Buyer agrees to make nominations, or to cooperate with Seller in the making of nominations, for well allowables (to be fixed or permitted by rules, regulations or orders of the Texas Railroad Commission) sufficient to cover the daily quantities which from time to time Buyer is entitled and elects to take hereunder up to the maximum quantity which in accordance with good engineering and gas produc-

1. Emphasis added throughout except where indicated otherwise.

tion practice can be produced from Seller's wells in the fields.

Beginning with the 1982 Contract Year (June 1, 1982 - May 31, 1983), and continuing through the 1985 Contract Year, Appellee failed to either take and pay or simply pay for the minimum quantity of gas required by the contract.

Pursuant to Article VIII, ¶ 8.2, of the contract, Appellants calculated the amount due from Appellee under the take-or-pay provision to be $21,264,689.30.

Article VIII, ¶ 8.2, provides:

> If Buyer shall fail in any contract year of the term hereof to take the quantity of gas that Buyer is obligated to take hereunder, then Seller shall, within sixty (60) days after such contract year render a bill to Buyer based upon the weighted average price, including tax reimbursement, in effect hereunder during the contract year in which such deficiency occurred, computed on the volumes delivered during the year and at the price, including tax reimbursement, applicable to such volumes at the time of delivery thereof. If Buyer agrees with such statement, Buyer will make payment to Seller for the amount of such statement within sixty (60) days after receiving Seller's statement. In computing the amount due Seller for any deficiency in takes by Buyer occurring during any contract year, there shall be deducted from such deficiencies the following quantities:
>
> (a) The total of the quantities which Buyer requested, up to 111% of the Daily Contract Quantity, and which Seller failed to deliver for any reason on any day or days during such contract year; and

> (b) The total of the quantities of gas which Buyer was unable to take or failed to take on any day or days during such contract year by reason of force majeure; and
>
> (c) The total of the quantities of gas by which there was a deficiency in Seller's allowable for the wells covered hereby below the Daily Contract Quantity on any day or days during such year, excluding any portion of such deficiency which is caused by, or is a result of, Buyer's failure to nominate to the Texas Railroad Commission to purchase a quantity of gas equal to the Daily Contract Quantity; and
>
> (d) The total of the quantities of gas which Buyer refuses to take on any day or days during such year by reason of Seller's failure to meet any of the quality specifications or pressure requirements provided hereunder.

In asserting that it had no liability to Appellants under the take-or-pay provision of the contract, Appellee relied upon evidence that it took the amount of gas under the contract that it was authorized to take under the Texas Gas Market Demand Rule. The amount of gas Appellee took under its contract with Appellants was determined by Appellee's market demand for gas as reflected in its monthly nominations for gas filed by Appellee with the Texas Railroad Commission.

The trial court submitted Appellants' take-or-pay claim by way of two special issues to the jury. Special Issue No. 2 inquired whether "Valero failed to take or pay for an amount of gas equal to the Daily Contract Quantity (DCQ)." Special Issue No. 3, concerning the amount of money Appellee owed Appellants for its failure to take or pay for gas under the contract, was conditionally

submitted by the trial court upon an affirmative finding being made by the jury to Special Issue No. 2. Since the jury answered Special Issue No. 2 in the negative, it did not answer Special Issue No. 3. On the basis of the jury's answer to Special Issue No. 2, the trial court entered judgment against Appellants on their take-or-pay claim. Other special issues were submitted to the jury, and the part of the judgment incorporating the jury's findings on them was not appealed.

The Texas Court of Appeals, in affirming the trial court's judgment, held that the Texas Gas Market Demand Rule applies so as to relieve Appellee of its obligations under the "take-or-pay" provision of the natural gas contract. *Lively Exploration Co. v. Valero Transmission Co.*, 751 S.W.2d 649 (Tex. App.—San Antonio 1988, writ denied); Appendix, p. 16. The court based its opinion upon the provisions of the contract, including Article XIII, ¶ 13.1, making the agreement "subject to all valid applicable federal and state laws or city ordinances, and to the orders, rules and regulations of any duly constituted federal or state regulatory body or authority having jurisdiction." 751 S.W.2d at 656; Appendix, p. 20.

I.

THE QUESTION IS SUBSTANTIAL

This case presents this Court with the substantial and novel question of whether the application of state ratable-take regulations to relieve pipeline purchasers of take-or-pay obligations and liability under natural gas contracts is preempted by the NGPA.

The Texas Court of Appeals premised its application of the Texas Gas Market Demand Rule on the above-

quoted government regulation clause, which is a standard provision in natural gas contracts. However, even if the contract did not include a government regulation clause, these laws and regulations would become a part of the contract and govern the transaction. *Wesseley Energy Corp. v. Jennings*, 736 S.W.2d 624 (Tex. 1987); *Langever v. Miller*, 124 Tex. 80, 76 S.W.2d 1025 (1934). Therefore, the effect of the Texas Court of Appeals' reliance upon the government regulation clause is to hold that the Texas Gas Market Demand Rule relieves *all* pipeline purchasers in Texas of their take-or-pay obligations under *all* of their natural gas contracts in the absence of an express provision to the contrary. The Texas Gas Market Demand Rule, as construed and applied by the Texas Court of Appeals, is preempted by the NGPA because it conflicts with the NGPA's goal of natural gas deregulation and reliance on market forces.

This case deserves the Court's attention "[b]ecause of the importance of the interstate market in natural gas." *Transcontinental Gas Pipe Line Corp. v. State Oil and Gas Board of Mississippi*, 474 U.S. 409, 411 (1986) ("*Transco*"). The Texas Court of Appeals' ruling is an unprecedented threat to natural gas price deregulation, because it invites the states to replace and second guess the purchasing decisions of the market. In *Transco*, 474 U.S. at 412, and *Northwest Central Pipeline Corp. v. State Corporation Commission of Kansas*, 489 U.S. ____, 103 L.Ed.2d 509, 522 (1989) ("*Northwest Central Pipeline*"), this Court recognized the crucial role take-or-pay clauses play in long-term natural gas contracts and encouragement of natural gas exploration and development. In light of the far-reaching adverse ramifications of the Texas Court of Appeals' decision on the NGPA's

goal of natural gas deregulation, this Court should note probable jurisdiction of this appeal.

Appellants' argument that the Texas Gas Market Demand Rule as applied by the Texas Court of Appeals is preempted by the NGPA rests on two considerations. First, the NGPA created a comprehensive scheme to govern future regulation of natural gas, and the Texas Gas Market Demand Rule as construed and applied by the Texas Court of Appeals falls "within the limits of that scheme, rather than within the category of regulatory questions reserved for the States." *Transco*, 474 U.S. at 420. Second, the Texas Gas Market Demand Rule as construed and applied by the Texas Court of Appeals "directly undermines Congress' determination that the supply, the demand, and the price of" interstate and intrastate natural gas "be determined by market forces." *Id.* at 422.

In 1963, this Court addressed the question of preemption under the Natural Gas Act of 1938, 15 U.S.C. §§ 717-717w, in the landmark case of *Northern Natural Gas Co. v. State Corporation Commission of Kansas*, 372 U.S. 84 (1962) ("*Northern Natural*"). The Court found Kansas' ratable-take orders were preempted, because they conflicted with the Federal Power Commission's authority under the NGA to regulate pipeline cost structure. The Court explained that:

> The federal regulatory scheme leaves no room either for direct state regulation of the prices of interstate wholesales of natural gas. *Natural Gas Pipeline Co. v. Panoma Corp.*, 349 U.S. 44, 99 L ed 866, 75 S Ct 576, or for state regulations which would in-

> directly achieve the same result. These state orders necessarily deal with matters which directly affect the ability of the Federal Power Commission to regulate comprehensively and effectively the transportation and sale of natural gas, and to achieve the uniformity of regulation which was an objective of the Natural Gas Act. They therefore invalidly invade the federal agency's exclusive domain (footnote omitted).

Id. at 91-92.

In *Transco*, the Court was "confronted again with the issue of a state regulation requiring an interstate pipeline to purchase gas from all the parties owning interests in a common gas pool." 474 U.S. at 411. The starting point of the Court's analysis in *Transco* was *Northern Natural*, which "struck down, on preemption grounds, a virtually identical regulation." *Id.* The Court then revisited *Northern Natural* in view of the NGPA, which extended Federal Energy Regulatory Commission ("FERC") authority to the intrastate market and phased in price deregulation of natural gas. The Court explained *Northern Natural* as follows:

> *Northern Natural's* finding of pre-emption thus rests on two considerations. First, Congress had created a comprehensive regulatory scheme, and ratable-take orders fell within the limits of that scheme rather than within the category of regulatory questions reserved for the States. Second, in the absence of ratable-take requirements, purchasers would choose a different, and presumably less costly, purchasing pattern. By requiring pipelines to follow the more costly pattern, Kansas' order conflicted with the federal interest in protecting consumers by ensuring low prices.

Id. at 420. The Court then applied those two considerations to the Mississippi ratable-take order and found that order was preempted by the NGPA. *Id.* at 424-25. The Court held that Mississippi's ratable-take regulations were preempted because "Mississippi's action directly undermines Congress' determination that the supply, the demand, and the price of high-cost gas be determined by market forces." *Id.* at 422.

The Court rejected the appellees' argument that "Congress, in enacting the NGPA, altered those characteristics of the federal regulatory scheme which provided the basis in Northern Natural for a finding of pre-emption." *Id.* at 417. The Court found that "[t]he NGPA . . . does not constitute a federal retreat from a comprehensive gas policy." *Id.* at 421. Deregulation was a congressional decision that market forces, and not federal or state regulation, should determine the demand and price for, and the conditions of sale and purchase of, natural gas. As stated by the Court in *Transco*:

> To the extent that Congress denied FERC the power to regulate affirmatively particular aspects of the first sale of gas, it did so because it wanted to leave determination of supply and first-sale price to the market. "[A] federal decision to forgo regulation in a given area may imply an authoritative federal determination that the area is best left *un*regulated, and in that event would have as much preemptive force as a decision to regulate" (emphasis in original). Arkansas Electric Cooperative Corp. v. Arkansas Public Service Comm'n, 461 US, at 384, 76 L Ed 2d 1, 103 S Ct 1905. Cf. Machinists v. Wisconsin Employment Relations Comm'n, 427 US 132, 150-151, 49 L Ed 396, 96 S Ct 2548 (1976).

Id. at 422.

The Court found that the comprehensive scheme under the NGPA had *broader* preemptive effect than the regulatory scheme under the NGA. The Court stated that the NGPA "has been justly described as 'a comprehensive statute to govern future natural gas regulation.' " *Id.* at 420-21 (quoting Note, *Legislative History of the Natural Gas Policy Act*, 59 Texas L. Rev. 101, 116 (1980)). The Court explained further that:

> [T]he NGPA reflects a congressional belief that a new system of natural gas pricing was needed to balance supply and demand. See S Rep No 95-436, at 10. The new federal role is to "overse[e] a *national market price regulatory scheme.*" Haase, 16 Houston L Rev, at 1079; see S Rep No 95-436, at 21 (NGPA implements "a new commodity value pricing approach"). The NGPA therefore does not constitute a federal retreat from a comprehensive gas policy. Indeed, *the NGPA in some respects expanded federal control, since it granted FERC jurisdiction over the intrastate market for the first time.* See the Act's §§ 311 and 312, 15 USC §§ 3371 and 3372.

Id. at 421.

Northern Natural and *Transco* invalidated state application of ratable-take orders to natural gas purchases. *Northern Natural* prohibits their application to purchasers of regulated gas, while *Transco* prohibits their application to purchasers of deregulated gas. The basic evil addressed by the Court in both cases was application of a ratable-take rule to impose purchasing requirements on pipelines different from that dictated by market demand.

The Court's recent opinion in *Northwest Central Pipeline* does not detract from its holdings in *Transco* and *Northern Natural*. The Court in *Northwest Central Pipe-*

line found that Congress had not occupied the field in which the Kansas regulation at issue in that case operates. That regulation provides for the permanent cancellation of producers' entitlement to quantities of Kansas - Hugoton gas in order to govern the timing of gas production. The Court specifically acknowledged *Transco* as "a case in which we had declared the post-NGPA vitality of Northern Natural's holding that state regulations requiring purchasers to take gas rateably from producers are pre-empted by the federal regulatory power over pipelines' costs and purchasing patterns." 103 L.Ed.2d at 526. The Court distinguished *Transco* on the grounds that the Kansas regulation was not directed at pipelines but "to the behavior of gas producers, and regulates their rates of production as a means of exercising traditional state control over the conservation of natural resources and the protection of correlative rights." *Id.* at 529. The Court explained the distinction between preempted state regulations and permissible state regulations as follows:

> In both Northern Natural and Transco, States had crossed the dividing line so carefully drawn by Congress in NGA § 1(b) and retained in the NGPA, trespassing on federal territory by imposing purchasing requirements on interstate pipelines. In this case, on the contrary, Kansas has regulated production rates in order to protect producers' correlative rights —a matter firmly on the State's side of that dividing line.

Id. at 530.

The Texas Gas Market Demand Rule as applied in the unprecedented manner by the Texas Court of Appeals in this case is preempted by the NGPA. Appellants do not contest the validity of the Texas Gas Market

Demand Rule as it had been applied prior to the Texas Court of Appeals' decision in this case. All other courts and the Texas Railroad Commission have recognized that contractual obligations to pay for gas not taken are not superseded by the Texas Gas Market Demand Rule. A discussion of the interpretation of the Texas Gas Market Demand Rule by the Texas courts and the Texas Railroad Commission is contained in Appellants' Application for Writ of Error to the Texas Supreme Court. *See* Appendix, pp. 86-91. That discussion indicates that the Texas Court of Appeals adopted a novel construction and application of the Texas Gas Market Demand Rule that has been rejected by all other Texas courts and the Texas Railroad Commission.

The Texas Gas Market Demand Rule requires pipeline companies to limit their purchases of gas to the pipeline company's downstream market demand and to "ratably apportion" its purchases so that takes from various gas producing properties shall be made without discrimination among producers in the same field and "without unjust or unreasonable discrimination . . . among the various fields from which it purchases gas." Appendix, pp. 287, 288, 301.

Analysis of the two considerations in *Transco* and *Northern Natural* reveals that the Texas Gas Market Demand Rule as applied by the Texas Court of Appeals is preempted by the NGPA. First, as construed and applied by the Texas Court of Appeals, the Texas Gas Market Demand Rule trespasses on territory that the NGPA reserved for the federal government. Second, as construed and applied by the Texas Court of Appeals, the Texas Gas Market Demand Rule directly undermines the deregulatory regime established by Congress in the NGPA.

The Texas Gas Market Demand Rule as construed and applied by the Texas Court of Appeals trespasses on territory that the NGPA reserved for the federal government. Construction and application of the Texas Gas Market Demand Rule to relieve a purchaser of his take-or-pay obligations and liabilities under a gas purchase contract is a direct state regulation of the purchasing patterns of natural gas pipelines and the terms of that purchase. Such a construction and application invades the sphere exclusively assigned to the federal government in *Northern Natural, Transco,* and *Northwest Central Pipeline.* The Court stated in *Northwest Central Pipeline* that:

> Interstate pipelines operate within the field reserved under the NGA for federal regulation, buying gas in one State and transporting it for resale in another, so inevitably the States are pre-empted from directly regulating these pipelines in such a way as to affect their cost structures. Ibid. Likewise in Transco, in which we considered whether the rule in Northern Natural had survived deregulation of many interstate rates by the NGPA, we held that federal authority over transportation and rates—now expressed in a determination that rates should be unregulated and settled by market forces—continued to occupy the field and to preempt state rateable-take orders directed to pipelines and forcing upon them certain purchasing patterns. 474 US, at 422-424, 88 L Ed 2d 732, 106 S Ct 709.

103 L.Ed.2d at 530. The Texas Gas Market Demand Rule as applied by the Texas Court of Appeals invades an area of federal responsibility that has been occupied to the exclusion of the states. That federal role entails a deregulatory regime in which market forces, and not state or federal regulation, govern purchasing patterns of

natural gas pipelines, the price of natural gas, and the conditions of purchase.

The Texas Gas Market Demand Rule as applied by the Texas Court of Appeals undermines the deregulatory regime established by Congress in the NGPA. Professor Richard Pierce, in an article cited in *Northwest Central Pipeline,* 103 L.Ed.2d at 522, states: "In analyzing the constitutionality of any state regulation that arguably interferes with the federal goal of relying on market forces, a good starting point is to compare the results of state regulation with the results of a properly functioning market." Pierce, *State Regulation of Natural Gas In A Federally Deregulated Market: The Tragedy of the Commons Revisited,* 73 Cornell L. Rev. 15, 40-41 (1987). This Court has employed such a method of analysis and has recognized that take-or-pay provisions are part of, and indeed essential to, the operation of market forces.

In *Transco,* the Court stated that "take-or-pay provisions are standard industry wide. See Pierce, 68 Va L Rev, at 77-78; H R Rep No. 98-814, pp. 23-25, 133-134 (1984)." 474 U.S. at 423. In describing the take-or-pay contracts involved in *Transco,* the Court stated:

> In line with prevailing industry practice, the contracts contained "take-or-pay" provisions. These essentially required Transco either to accept currently a certain percentage of the gas each well was capable of producing, or to pay the contract price for that gas with a right to take delivery at some later time, usually limited in duration. Take-or-pay provisions enable sellers to avoid fluctuations in cash flow and are therefore thought to encourage investments in well development. See Pierce, Natural Gas Regula-

> tion, Deregulation, and Contracts, 68 Va L Rev 63, 77-79 (1982).

Id. at 412.

In *Northwest Central Pipeline*, the Court cited the parties' failure to negotiate a take-or-pay provision as evidence of the absence of market forces:

> The interstate pipelines generally entered into their current contracts to purchase Kansas-Hugoton gas at a time when the market was little developed and oligopsonic. These contracts usually provide for relatively low prices and do not contain "take-or-pay" provisions requiring the purchaser to pay for some minimum quantity of gas irrespective of whether it takes current delivery.

103 L.Ed.2d at 522.

Thus, the Texas Gas Market Demand Rule as construed and applied by the Texas Court of Appeals so as to relieve Appellee of its take-or-pay obligations directly undermines a standard contract provision that this Court has recognized is essential to the effective operation of a deregulated gas market.

No doubt exists that this Court's analysis of the role of take-or-pay provisions in a properly functioning market is correct. A take-or-pay clause is essential to the allocation of risk in a long-term gas contract and is a form of valuable consideration in such a contract. As stated in *Universal Resources Corp. v. Panhandle Eastern Pipeline Co.*, 813 F.2d 77, 80 (5th Cir. 1987):

> The purpose of the take-or-pay clause is to apportion the risks of natural gas production and sales between

> the buyer and seller. The seller bears the risk of production. To compensate seller for that risk, buyer agrees to take, or pay for if not taken, a minimum quantity of gas. The buyer bears the risk of market demand. The take-or-pay clause insures that if the demand for gas goes down, seller will still receive the price for the Contract Quantity delivered each year.

As explained in Medina, *The Take-Or-Pay Wars: A Further Status Report,* 41 Okla. L. Rev. 381, 384 (1988):

> [A] long-term gas contract by its very nature involves an exchange of valuable consideration. The pipeline is given the exclusive right to take the producer's gas for a term of years at an agreed price or pricing formula, thereby acquiring a contractually assured supply. The producer is assured a market, but relinquishes his right to sell gas to third-parties. The take-or-pay clause ensures the producer a minimum cash stream whether or not the gas is taken.

Had Appellee wanted to limit its takes of gas under its contract with Appellants during periods when gas was in surplus supply, it could have negotiated a market-out clause. The contract was drafted by sophisticated attorneys for clients with substantial experience in gas production and marketing. Appellee signed a contract for mandatory minimum takes during a period of inflated gas prices, because it gambled that the economy would remain favorable to gas supplies.

In addition, preservation of contractual expectations is essential for a properly functioning market. Government intervention to reallocate foreseeable business risks undermines contractual stability and creates a market distortion by discouraging parties from entering into long-term con-

tracts. *See* Medina, McKenzie, & Daniel, *Take or Litigate: Enforcing the Plain Meaning of the Take-or-Pay Clause in Natural Gas Contracts*, 40 Ark. L. Rev. 185, 218 (1986) ("A persuasive case can be made for the proposition that enforcement of take-or-pay clauses serves the national interest in encouraging producers of gas to enter into long-term contracts").

Thus, the Texas Gas Market Demand Rule as construed and applied by the Texas Court of Appeals to vitiate an arms-length, long-term gas supply contract directly conflicts with Congress' decision "to leave determination of supply and first-sale price to the market." 474 U.S. at 422.

ANR Pipeline Co. v. Corporation Commission of the State of Oklahoma, 860 F.2d 1571 (10th Cir. 1989), *cert. denied*, 490 U.S.____, 104 L.Ed.2d 435 (1989), involved an Oklahoma statute and rule which, like the Texas Gas Market Demand Rule, required "every purchaser of natural gas to purchase all of the natural gas offered for sale from a common reservoir (without discrimination in favor of one producer as against another, or in favor of one source of supply as against another), and, if the purchaser is unable to do so, then it must purchase natural gas from each producer ratably." 860 F.2d at 1581. The court held that "all state regulation of the *purchasing or taking* of natural gas by interstate pipeline companies has been pre-empted by the federal regulations contained in the Natural Gas Act and the Natural Gas Policy Act of 1978 (emphasis in original)." *Id.* The court concluded that the Oklahoma statute and rule "interfere with federal regulation of the purchase of natural gas" and "are pre-empted because they create an obstacle to full compliance with the objectives of the federal regulations." *Id.* at 1582.

A substantial federal question is raised in this case under the preemption doctrine applied by this Court in *Northern Natural, Transco,* and *Northwest Central Pipeline.* The ramifications of the Texas Court of Appeals' decision are far-reaching, because the effect of that court's reliance upon the government regulation clause is to hold that the Texas Gas Market Demand Rule relieves *all* pipeline purchasers in Texas of their take-or-pay obligations under all of their natural gas contracts in the absence of an express provision to the contrary. The opinion of the Texas Court of Appeals and the Texas Supreme Court's denial of Appellants' application for writ of error already have resulted, and will continue to result, in reliance by pipeline companies on the Texas Market Demand Rule as a complete defense to liability under the take-or-pay provisions of natural gas contracts.[2]

II.

This case also presents this Court with the substantial and novel question of whether application of state ratable-take regulations to relieve pipeline purchasers of take-or-pay obligations and liability under natural gas contracts violates the Commerce Clause of the United States Constitution. The Texas Court of Appeals' construction of the Texas Gas Market Demand Rule fails to pass the balancing test outlined by this Court in *Pike v. Bruce Church, Inc.,* 397 U.S. 137 (1970), and followed in later decisions. The Kansas regulations this Court upheld as valid under the Commerce Clause in *Northwest Central Pipeline* were "intended to protect correlative rights by

2. The use of the Texas Court of Appeals' opinion in other cases is discussed in Appellants' Motion for Rehearing before the Texas Supreme Court. *See* Appendix, pp. 127-28.

encouraging production of allowables, aimed at producers and *requiring nothing of purchasers.*" 103 L.Ed.2d at 536. The Texas Gas Market Demand Rule, however, applies directly to pipeline purchasers and as applied by the Texas Court of Appeals is a direct interference with the purchase of natural gas and invalid under the Commerce Clause.

The Commerce Clause analysis applies to this case even though the contract at issue is an intrastate gas sale contract. As recognized in *Transco*, the NGPA resulted in "unification of the interstate and intrastate markets," and now there is a "national natural gas market." 474 U.S. at 423-24. Congress "recognized the need to eliminate the distinction between the interstate and intrastate markets. Because the regulation-free intrastate market had imposed an opportunity cost on the interstate supply, Congress imposed price controls on intrastate gas in sections 105 and 106(b)." Note, *Legislative History of the Natural Gas Policy Act*, 59 Tex. L. Rev. 101, 120 (1980).

The authority given by the NGPA to FERC to regulate the price of "all first sales of natural gas irrespective of its interstate or intrastate character" was upheld in *State of Oklahoma v. Federal Energy Regulatory Commission*, 661 F.2d 832 (10th Cir. 1981), *cert. denied*, 457 U.S. 1105 (1982). The court there held that "the enactment of the NGPA is a constitutionally acceptable exercise of Congress' Commerce Clause power." 661 F.2d at 838. The basis of the court's holding, among other things, was that Congress may regulate wholly intrastate activities which have "a substantial economic effect on interstate commerce or when the intrastate activity is necessary to effectuate the interstate regulation"; "Congress had a

rational basis for determining that the unregulated intrastate market imposed a burden on interstate commerce"; and "Congress may preempt state conservation regulations which interfere with or burden interstate commerce." *Id.* at 834-35.

In considering the validity of state ratable-take rules such as the Texas Gas Market Demand Rule, there is no longer any valid reason for differentiating between interstate and intrastate pipelines. The Texas Gas Market Demand Rule does not distinguish between interstate and intrastate pipelines. Interstate and intrastate pipelines compete for the same gas and purchase from the same producers, the same fields, and even the same wells, and the maximum price of the first sales to them is regulated by FERC irrespective of the destination of the gas. Their purchasing practices and other actions have a definite impact upon each other and upon the national natural gas market which now exists as a result of the unification of the interstate and intrastate markets by the NGPA.

The Commerce Clause prevents states from erecting barriers to the free flow of interstate commerce even in the absence of congressional exercise of power to regulate commerce among states. As explained by this Court in *Raymond Motor Transportation, Inc. v. Rice,* 434 U.S. 429, 440 (1978):

> By its terms, the Commerce Clause grants Congress the power "[t]o regulate Commerce . . . among the several States. . . ." Long ago it was settled that even in the absence of a congressional exercise of this power, the Commerce Clause prevents the States from erecting barriers to the free flow of interstate commerce. Cooley v. Board of Wardens, 12 How

299, 13 L Ed 996 (1952); see Great A&P Tea Co. v. Cottrell, 424 US 366, 370-371, 47 L Ed 2d 55, 96 S Ct 923 (1976).

The Court then explained the *Pike* balancing test as follows:

> Our recent decisions make clear that the inquiry necessarily involves a sensitive consideration of the weight and nature of the state regulatory concern in light of the extent of the burden imposed on the course of interstate commerce. As the Court stated in Pike v. Bruce Church, Inc., 397 US 137, 142, 25 L Ed 174, 90 S Ct 844 (1970):
>
> > Although the criteria for determining the validity of statutes affecting interstate commerce have been variously stated, the general rule that emerges can be phrased as follows: Where the statute regulates evenhandedly to effectuate a legitimate local public interest, and its effects on interstate commerce are only incidental, it will be upheld unless the burden imposed on such commerce is clearly excessive in relation to the putative local benefits. Huron Cement Co. v. Detroit, 362 U.S. 440, 443, [4 L Ed 2d 852, 80 S Ct 813, 78 ALR2d 1294]. If a legitimate local purpose is found, then the question becomes one of degree. And the extent of the burden that will be tolerated will of course depend on the nature of the local interest involved, and on whether it could be promoted as well with a lesser impact on interstate activities.

This Court's Commerce Clause analysis has distinguished between state conservation regulations intended to protect correlative rights and aimed at producers and requiring nothing of purchasers and state conservation measures that are aimed at purchasers and the conditions

of natural gas purchases. In *Northwest Central Pipeline*, the Court held that a Kansas conservation "regulation intended to protect correlative rights by encouraging production of allowables, aimed at producers and requiring nothing of purchasers" did not violate the Commerce Clause. 103 L.Ed. at 536. The Court based its decision on the fact that the Kansas regulation is consistent with the NGA and the NGPA and does not disrupt commerce, and the statute "is an exercise of Kansas' traditional and congressionally recognized power over gas production." *Id.* at 537. In contrast, a Kansas ratable-take order directed at gas purchasers was invalidated partly on Commerce Clause grounds in *Northern Natural*. The Court explained that "our cases have consistently recognized a significant distinction, which bears directly upon the constitutional consequences, between conservation measures aimed directly at interstate purchasers and wholesalers for resale, and those aimed at producers and production." 372 U.S. at 94.

The Texas Gas Market Demand Rule as construed and applied by the Texas Court of Appeals violates the Commerce Clause, because (1) it is not an exercise of traditional state conservation functions and (2) it constitutes an impermissible burden on interstate commerce. The traditional conservation functions assigned to the states do not include the power to abrogate contract rights and obligations between parties to a natural gas contract between a producer and a gas pipeline purchaser.

In *Champlin Refining Co. v. Corporation Commission of Oklahoma*, 286 U.S. 210, 235 (1932), the Court upheld Olahoma's market demand prorationing statutes on the basis that they "apply only to production and not to

sales or transportation of crude oil or its products." The Court further stated that "[s]uch production is essentially a mining operation, and therefore, is not part of interstate commerce." *Id.* In both *Northern Natural* and *Northwest Central Pipeline*, the Court emphasized that state regulations aimed at purchasers are not within the traditional state conservation function and do not pass constitutional muster. The Court stated in *Northern Natural:*

> [A] purpose, however legitimate, to conserve natural resources, does not warrant *direct* interference by the States with the prices of natural gas wholesales in interstate commerce, Cities Service Gas Co. v. State Corp. Com. 355 US 391, 2 L ed 2d 355, 78 S Ct 381; Michigan Wisconsin Pipe Line Co. v. Corporation Com. 355 US 425, 2 L ed 2d 412, 78 S Ct 409 (emphasis in original).

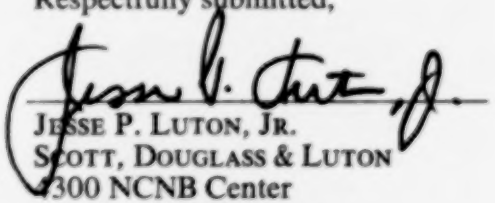
372 U.S. at 93.

Interstate commerce is impermissibly burdened by the Texas Gas Market Demand Rule as construed and applied by the Texas Court of Appeals. Take-or-pay provisions are an essential part of market forces, and their enforcement is essential for contractual stability and encouragement of long-term natural gas contracts. *See supra*, p. 23. The application of the Texas Gas Market Demand Rule to vitiate a take-or-pay provision is thus a direct and serious burden on interstate commerce. This burden is especially significant in light of Congress' determination in the NGPA that the purchase of natural gas be regulated by market forces and not by state or federal regulation.

CONCLUSION

For these reasons, this Court should note probable jurisdiction of this appeal.

Respectfully submitted,



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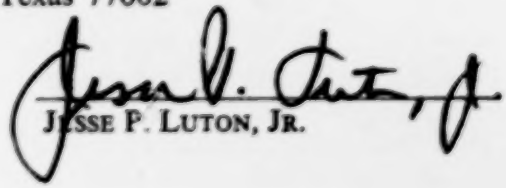
Counsel for Appellants

December 7, 1989

CERTIFICATE OF SERVICE

I hereby certify that Appellants' Jurisdictional Statement was served on the Appellee by depositing it in a United States post office or mailbox, with first class postage prepaid, on the 7th day of December, 1989, addressed to Appellee's counsel of record as follows:

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